

Summary of Testimony of Dr. Lee L. Selwyn

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Presented on behalf of Western Wireless Corp.

Federal-State Joint Board on Universal Service
en banc Hearing on High-Cost Universal Service Support
in Areas Served by Rural Carriers

Panel 1: Support in Areas Served by Rural Carriers and the
Definition of “Rural Telephone Company”

Nashville, TN – November 17, 2004

USF policy: A focus on *consumers*

- The '96 Act's universal service focus is on *consumers* – not on *providers*.
- At bottom, providers have no inherent *entitlement* to high-cost funding except where it supports statutory *consumer-oriented* goals.
- Existing distinctions between “small rural ILECs” and other “high cost” providers must be examined solely in terms of how the statutory goals of universal service can be achieved most efficiently.

Institutionalized inefficiency

- The existing distinction between “small rural ILECs” and other high cost providers encourages ILECs to “game the system” and fosters inefficiency and waste.
- Large ILECs are encouraged to divest rural exchanges, and mid-size ILECs that serve rural areas are encouraged to maintain fictitious “small rural ILECs” by carving up their companies into multiple “study areas.”

Gaming the system

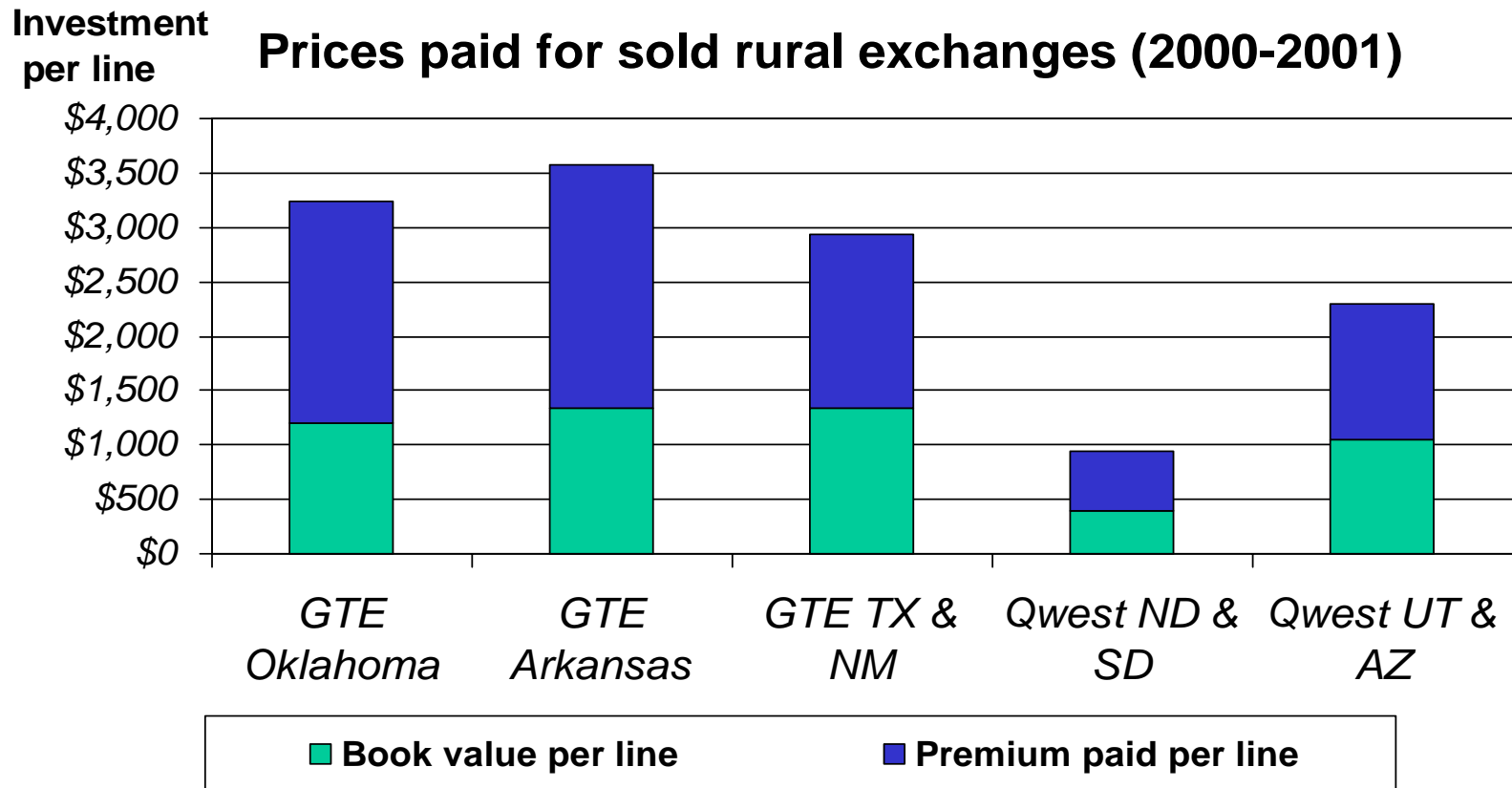
- Many RLECs drawing high cost support are also earning excessive rates of return.
- Only 42 of the 1400 RLECs actually file earnings reports. We don't know anything about the others.
- Of those 42, 19 report RORs in excess of 12%.

Many RLECs drawing HCF support are producing excessive earnings

Company	Access Lines	Interstate ROR	2003 HCF Disbursements
ACS of Anchorage	180,407	19.12%	\$ 2,033,892
C-R Telephone Company	936	29.48%	\$ 688,992
Century Tel of Midwest Michigan	30,437	16.48%	\$ 7,113,876
Century Tel of Wisconsin	411,489	24.26%	\$ 28,819,328
Chillicothe Telephone Company	37,201	18.35%	\$ 10,905,816
Coastal Utilities	41,585	17.55%	\$ 6,465,408
Concord Telephone	124,832	18.59%	\$ 2,116,620
El Paso Telephone	2,201	25.68%	\$ 479,688
Fort Mill Telephone	21,331	18.55%	\$ 4,352,748
Gallatin River	81,325	14.50%	\$ 457,104
Gulf Telephone	57,253	17.37%	\$ 2,339,532
Illinois Consolidated Telephone	84,568	14.15%	\$ 2,859,000
Lancaster Telephone	26,044	14.14%	\$ 3,208,764
Rock Hill	56,726	14.88%	\$ 4,182,204
TXU Communications	123,896	15.11%	\$ 6,992,868
Virgin Islands Telephone	69,073	15.88%	\$ 26,655,060

Gaming the system

- Investors are consistently willing to pay premiums over book value for ILECs able to draw high cost support



RBOC exchanges sold to smaller ILECs commanded a Premium of more than double the Net Book Cost of the assets

Seller	State / Sale Date	No. of Lines	Cash Price (000)	Estimated Net Book Value (000)	Premium over Book Value (000)	Premium paid per Line (000)
GTE	Oklahoma June 2000	130,000	\$420,300	\$155,800	270%	\$2,035
GTE	Arkansas July 2000	93,000	\$332,900	\$124,000	268%	\$2,246
GTE	TX & NM August 2000	425,000	\$1,249,600	\$568,000	220%	\$1,604
Qwest	ND & SD 2000	20,000	\$19,000	\$8,000	238%	\$550
Qwest	UT & AZ 2001	41,000	\$94,000	\$43,000	219%	\$1,244

Investors have capitalized rural ILEC holding company earnings at multiples of book value, and would continue to do so even without high cost support

Holding Company	Study Areas	Access Lines	Market Cap (millions)	Book Value (\$millions)	Investor Premium (\$millions)	Ann. USF Draw (\$millions)
AllTel	57	2,748,487	\$16,940	\$6,997	\$9,943	\$164.2
CenturyTel	88	2,179,835	\$4,470	\$3,407	\$1,063	\$310.9
Citizens	48	1,274,019	\$4,690	\$1,384	\$3,326	\$110.2
Valor	8	536,274	\$875	\$49	\$826	\$15.6

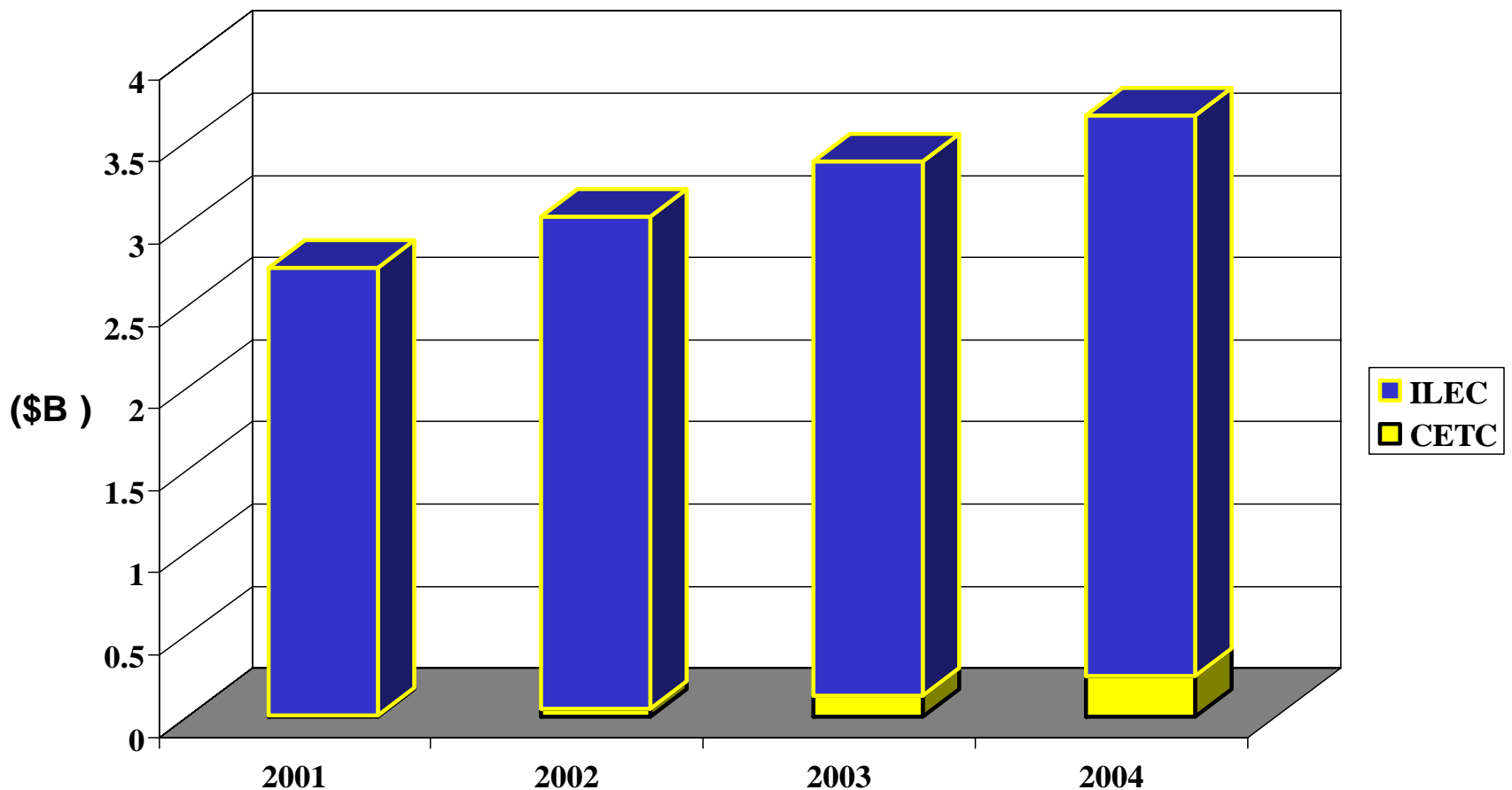
Gaming the system

- Carriers claiming need for multiple “study areas” nevertheless manage these areas on an integrated basis. For example:
 - Century Tel owns two operating companies in Oregon
 - Each Company makes a substantial payment to the parent CenturyTel “Service Group”
 - CT of Oregon – 42,414 access lines
 - \$9.94 per access line per month (35% of total \$27.96 in operating expenses)
 - CT of Eastern Oregon – 34,337 access lines
 - \$11.28 per access line per month (28% of total \$39.69 in operating expenses)

ILEC demand for high-cost support continues to escalate

- Under RORR, ILECs assume no competitive or other risks, and draw high cost support without any requirement to demonstrate that “costs” for which reimbursement is sought are reasonable, necessary, or efficiently incurred.
- The minimal level of high cost support flowing to CETCs is not the source of this growth.

ILEC demand for high-cost support continues to escalate

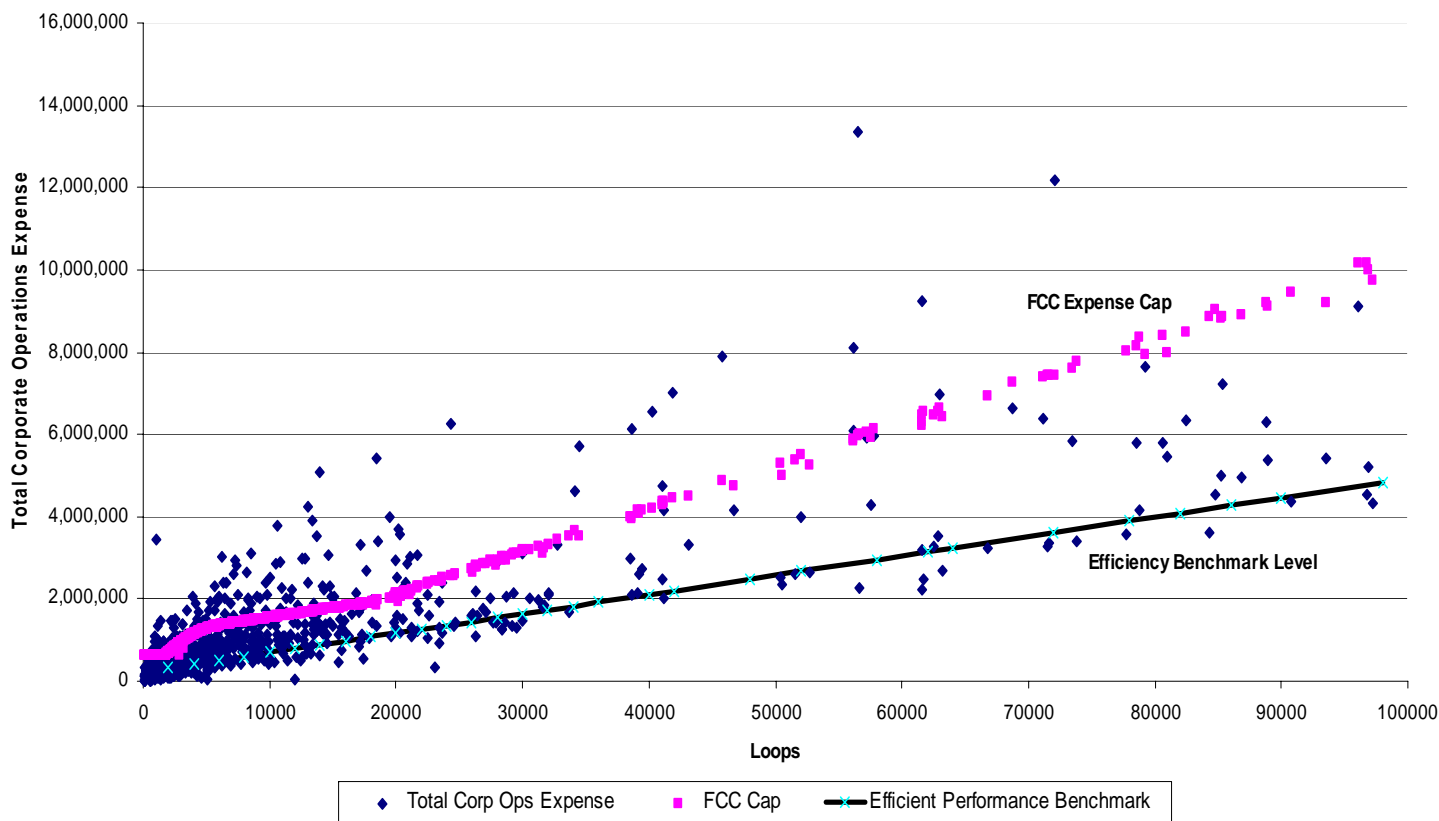


ILEC demand for high-cost support continues to escalate

- No reasonable basis exists to explain the enormous variation in the level of RLEC overhead costs.
- Recovery should be limited to level of 25% “best in class” – a presumptively efficient expense level.
- This policy would reduce the aggregate level of high cost support by \$545-million.

ILEC demand for high-cost support continues to escalate

Overhead costs for many are excessive relative to “best in class”



Forward-looking costs

- Provide sufficient level of high-cost support to permit recovery of additional investment and ongoing operating costs going forward.
- Assure standardized cost estimation, limit opportunities for gaming
- Are competitively neutral as between RLECs and CETCs

Forward-looking costs

- The use of embedded cost as the basis for RLEC high cost support is demonstrably inefficient and unnecessary
- Produces excessive earnings
- Support payments are capitalized by investors at premium values

Forward-looking costs

- The use of embedded cost as the basis for RLEC high cost support does not protect consumers
- Distorts efficient technology choices
- Discourages competitive entry
- Denies rural customers benefits of competition and innovation
- Violates overarching goal of '96 Act: “To promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.”

Forward-looking costs

- When RORR was widely used as basis for rate-setting, ILEC had the “burden of proof” of need for additional revenues, and regulators conducted extensive evidentiary reviews of ILEC evidence.
- In stark contrast, RLEC claims for high-cost support based upon embedded cost receive little or no review.
- RLECs seek to shed burden of proof by arguing that they should be presumed to be operating efficiently.
- In reality, RLECs are not being regulated under RORR *in practice* – no one is minding the store!

Forward-looking costs

- All ETCs (rural and non-rural incumbents and competitors) should be subject to equal, competitively-neutral treatment with respect to high cost support.
- The basis for high cost support for all ETCs should be the cost for the most efficient ETC.
- The distinction between small RLECs and other carriers with respect to the use of embedded vs. forward-looking cost should be eliminated, and all ETCs should receive funding based on forward-looking cost.